

STATE OF IOWA  
DEPARTMENT OF COMMERCE  
UTILITIES BOARD

IN RE:  AQUILA, INC., d/b/a AQUILA NETWORKS	DOCKET NO. SPU-03-7
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**ORDER NOT DISAPPROVING PROPOSAL FOR REORGANIZATION, DENYING  
REQUEST FOR EXTENSION OF AUTHORITY, AND REQUIRING REPORTS**

(Issued October 27, 2003)

**PROCEDURAL HISTORY**

On April 30, 2003, Aquila, Inc., d/b/a Aquila Networks (Aquila), filed a request for expedited waiver of the provisions of 199 IAC Chapter 32 to permit Aquila to proceed with a pledge of Iowa utility assets to secure a revised credit agreement. Aquila requested, in the alternative, that the Utilities Board (Board) approve a proposal for reorganization, pursuant to Iowa Code §§ 476.76 and 476.77 (2003), that includes the proposed pledge of Iowa regulated utility assets and grant Aquila the authority to extend the pledge beyond the three-year term of the revised credit agreement. Aquila is a regulated utility providing natural gas service in Iowa.

On May 21, 2003, the Board issued an order denying the request for expedited waiver and establishing a procedural schedule for consideration of the proposal for reorganization. On June 13, 2003, the Board issued an order rescheduling the hearing to August 19, 2003, and indicating the Board would be

issuing an order with questions for the parties after Aquila filed rebuttal testimony. Aquila filed rebuttal testimony on June 17, 2003.

On July 3, 2003, the Board issued an order rescheduling the hearing from August 19, 2003, to August 26, 2003, and directed the parties to respond to certain questions. Aquila and the Consumer Advocate Division of the Department of Justice (Consumer Advocate) responded with supplemental prefiled testimony with responses to the Board's questions.

The hearing was held on August 26, 2003. Briefs were filed by Aquila and Consumer Advocate. Iowa Code § 476.77(3) establishes five factors that the Board may consider in determining whether to disapprove a proposal for reorganization. The Board will address Aquila's proposal for reorganization to pledge Iowa utility assets using those five factors and other factors that the Board considers relevant to the decision.

## **INTRODUCTION**

As required by Iowa Code §§ 476.76 and 476.77 and Board rule 199 IAC 32, Aquila filed a proposal for reorganization with supporting testimony and evidence in which Aquila proposes to pledge its Iowa utility assets to support a \$430 million three-year term loan. Aquila also requested the Board grant Aquila the authority to extend the pledge of assets to any future extension or rollover of the three-year term loan and future replacement debt offering for the working capital requirement of Aquila's domestic utility operations.

Aquila stated that it filed the proposal for reorganization to pledge Iowa utility assets as one part of an overall debt and restructuring plan (Plan). The Plan is necessary to allow Aquila to continue in business after credit agencies significantly increased the credit requirements for Aquila's energy merchant business. Aquila stated that it did not have sufficient capital to meet these new requirements and, therefore, chose to exit the energy merchant market.

Aquila's Plan includes two phases that, when completed, will leave Aquila as a domestic utility company only. The first phase, which has been completed, included: 1) reduction of unnecessary operating expenses; 2) closing of Aquila's merchant trading operations; 3) selling of \$1.3 billion in assets; 4) reduction of debt by more than \$1 billion; and 5) elimination of Aquila's common stock dividend. The second phase involves: 1) selling Aquila's remaining international and non-core domestic assets; 2) buying out certain tolling contracts; 3) restructuring other liabilities; and 4) ensuring that the Plan does not adversely affect Aquila's utility operations and its customers.

To accomplish phase two, Aquila needed to replace two revolving credit facilities by April 12, 2003, and obtain enough working capital to support operations. Aquila replaced the revolving credit facilities by entering into a loan agreement for a \$430 million three-year term loan. As part of the loan agreement, Aquila agreed to make commercially reasonable efforts to obtain approval from the Iowa, Missouri, Minnesota, Kansas, and Colorado regulatory agencies to pledge regulated utility assets to secure the loan.

Aquila's Canadian assets, as well as its Nebraska and Michigan utility assets, were used as collateral to secure the loan. Of that loan, Aquila determined that \$250 million was needed for working capital requirements of the utility operations. However, the value of the Nebraska and Michigan assets was not sufficient to support the \$250 million requirement. The Canadian assets were needed to cover the gap. Aquila believes it is appropriate to ensure proper alignment of domestic utility collateral with domestic utility needs. Therefore, Aquila is seeking to pledge additional assets to replace the Canadian assets. Aquila proposed to sell the Canadian assets and use the proceeds to repay the term loan until the remaining utility collateral value equals or exceeds 1.67 times the then-outstanding term loan balance. Aquila, at the Board's request, filed late-filed Exhibit 129 that indicates that the Canadian assets have been sold.

Consumer Advocate recommended the Board disapprove the proposal for reorganization. Consumer Advocate contended that there would be no significant adverse consequences if the request is denied and the funds from the \$430 million term note are not needed to provide working capital for Aquila's Iowa utility operations. Consumer Advocate argued that Aquila's future ability to attract capital on reasonable terms may be impaired by securing assets it does not need to secure at this time and not disapproving the proposal will allow the company to continue its policy of commingling regulated and nonregulated finances. Consumer Advocate contended that the commingling of regulated and nonregulated assets has led to the deterioration and impairment of Aquila's regulated electric and gas utility credit rating.

## **STATUTORY FACTORS**

Iowa Code § 476.77 lists five factors the Board may consider in its review of the proposal for reorganization. The Board will address each of these factors separately.

**1. Whether The Board Will Have Reasonable Access To Books, Records, Documents, And Other Information Relating To The Public Utility Or Any Of Its Affiliates**

The Board finds that it will continue to have reasonable access to books and records. This factor was not contested.

**2. Whether The Public Utility's Ability To Attract Capital On Reasonable Terms, Including The Maintenance Of A Reasonable Capital Structure, Is Impaired**

**A. Aquila's argument**

Aquila stated that it intends to maintain its capital allocation process, including the comparable company debt/equity ratios and the current long-term debt assignment process, during the tenure of its Plan. The proposed pledge of assets will help to provide the working capital needed to execute the Plan and fulfill its commitment to maintain the capital allocation process. Therefore, the proposed pledge will benefit, not impair, Aquila's ability to attract capital on reasonable terms and maintain a reasonable capital structure. In response to Consumer Advocate's concern about reserving utility assets for possible future financing, Aquila asserted that all pledged assets in excess of 1.67 times the loan balance at that time would be available to Aquila to support any additional capital needs.

**B. Consumer Advocate's argument**

Consumer Advocate contended that Aquila's regulated utility assets should not be pledged unnecessarily. Pledging Iowa assets is not required at this time and denial of the proposal for reorganization would not result in any adverse consequences for Aquila. By using the assets as security for the loan it already has, Aquila is limiting its ability to use its utility assets for additional financings in the future. Aquila's credit has already suffered significant impairment and pledging would be imprudent unless required as a condition for receiving financing.

Consumer Advocate then argued that while the interest rate on the \$430 million term loan will be reduced by 75 basis points if adequate utility assets are pledged, this loan is not reflected in rates in Iowa, so there is little, if any, direct benefit to the utility customers. Furthermore, rates should reflect only prudently-incurred costs associated with an investment grade rating, but Aquila will be tied indefinitely to a financially weakened firm. This leaves the utility operations at some risk, which will keep the cost of capital relatively high. Consumer Advocate witness Vitale testified that Aquila's agreement to restrictive covenants in the loan agreement, together with its failed policy of commingling regulated utility operations with its remaining nonregulated operations, "will impede its utility operations from regaining an investment grade bond rating."

**C. Board analysis**

The evidence indicates that Aquila's overall ability to attract capital has been seriously impaired by problems resulting from its debt-financed nonregulated

activities and the proposal for reorganization is a consequence of that impairment. Since Aquila maintains its public utility as a division of the company and all finances, both regulated and nonregulated, are commingled, the public utility's ability to attract capital is also impaired.

During its debt-financed expansion into high-risk nonregulated business activities, Aquila sought Board approval on the premise that there would be no detriment or risk to regulated activities resulting from the expansion. Aquila's assurances have not been fulfilled and Aquila is now asking the Board for help in recovering from its aggressive nonregulated business practices. Aquila asserts that the proposed pledge will benefit, not impair, Aquila's ability to attract capital on reasonable terms and maintain a reasonable capital structure.

The Board agrees with Consumer Advocate that being tied indefinitely to a financially weakened firm leaves Aquila's utility operations at risk and may keep the cost of capital relatively high. The Board also agrees that there is a risk that Aquila's failed policy of commingling regulated utility operations with its remaining nonregulated operations may impede its utility operations from regaining an investment grade bond rating.

However, the Board finds the evidence supports the conclusion that the \$430 million three-year loan was necessary to provide liquidity, given Aquila's technical default on prior loans. The new lenders were in a strong position to dictate terms and apparently were willing to provide funds only if sufficient assets were pledged and at an interest rate of 8.75 percent. Although Aquila has enough assets currently to

support the \$250 million portion of the loan used for cash working capital, the evidence indicates that by pledging Iowa assets Aquila may meet the requirements for reducing the interest rate on the loan from 8.75 percent to 8 percent. To qualify for this reduction, a value of approximately \$718 million in utility assets would need to be pledged, which is 1.67 times the \$430 million loan. This interest rate reduction would produce annual savings of approximately \$3.225 million of interest expense.

Further, the evidence indicates that if the amount of assets in the collateral pool is greater than the amount required to support the three-year term loan, Aquila would be able to use those excess assets as collateral for additional loans, if appropriate. Even if the assets are needed to support the loan, those assets still can be sold as long as the proceeds from the sale are used to reduce the amount of the loan such that the value of the remaining assets equals or exceeds 1.67 times the loan value. Based on this evidence, the Board concludes that in Aquila's situation, disapproval of the proposal for reorganization would have an adverse effect on the ability of Aquila's Iowa utility operations to attract additional capital on reasonable terms. Allowing Aquila to pledge the Iowa assets will facilitate the saving of \$3.225 million of annual interest expense and improve Aquila's access to capital markets.

The Board agrees with Consumer Advocate that the commingling of regulated and nonregulated operations was a primary cause of the current financial crisis for Aquila's regulated utility operations. However, if Aquila does restructure into a regulated domestic utility only, commingling should no longer be an issue. The consequences of Aquila's current financial crisis may hang over the utility for a long



time and make it difficult to improve its ability to attract capital. However, from a ratemaking perspective, the Board will be able to retain oversight of the level of capital costs included in rates if Aquila remains a viable corporation. The alternative could conceivably include bankruptcy, which could affect the Board's ability to protect customer interests.

By allowing Aquila to pledge its Iowa regulated assets to assure its liquidity, Aquila will be able to sell other company assets and reduce the debt associated with its nonregulated activities. The Board finds this will enhance Aquila's ability to attract capital, aid in a return to a reasonable capital structure, and support the transition to a utility-only company.

**3. Whether The Ability Of The Public Utility To Provide Safe, Reasonable, And Adequate Service Is Impaired**

Aquila asserted that it has maintained and in most cases improved its performance for the past year with respect to new connections, responding to complaints, billing accuracy, and emergency services. Aquila maintained it is committed to continuing to deliver quality services to its customers. It has developed internal service quality metrics for meter reading accuracy, emergency response time, safety, generation availability, heat rates, and call center performance. Aquila noted that no Iowa-based employees were terminated as part of its recent workforce reductions. On the basis of this evidence, Aquila asserted that its ability to provide safe, reasonable, and adequate service would not be impaired by the proposed reorganization. Consumer Advocate did not contest this issue.

Aquila recognized it has deficiencies within its call center operations and is making an effort to improve the level of service by increasing the expertise of its employees, reducing the abandoned call rate, and reducing call hold times. The Board considers the use of the Gallup organization to perform monthly surveys of customers to be a useful tool in monitoring service quality. To enable the Board to monitor Aquila's success in correcting the service deficiencies and in maintaining adequate service, the Board will require Aquila to file the Gallup survey results with the Board.

At the hearing, the Board asked Aquila about an apparent discrepancy in the number of emergency call response times over 60 minutes. The evidence presented by Aquila in this proceeding and the information obtained by the Board's safety inspectors during inspections of Aquila operations did not match. Aquila filed late-filed Exhibit 128 in an attempt to address this discrepancy. The Board is not satisfied that Exhibit 128 provides a complete explanation of the discrepancies and will require further reporting of leak call responses over 60 minutes. The Board will require Aquila to file, in a separate docket, a list of leak call responses taking over 60 minutes and an explanation for the delay in responding to each call.

The Board finds that the evidence in the record concerning Aquila's quality of service is not sufficient to disapprove the proposal for reorganization. This is an area of special concern to the Board and the Board will continue to monitor Aquila's commitment and actions with regard to its service obligations to ensure that Aquila's financial problems do not adversely affect service quality.

**4. Whether Ratepayers Are Detrimentially Affected**

**A. Aquila's argument**

Aquila stated in its application that it is not possible to quantify the potential financial impact on ratepayers of the pledging of Aquila's Iowa utility assets. However, Aquila committed to protect utility customers from potential adverse financial impacts associated with implementation of the debt reduction and financial restructuring plan. In order to accomplish this, Aquila committed to maintain its capital allocation process that utilizes hypothetical capital structures and long-term debt assignments and to establish rates for customers based on new or replacement debt as if such debt were investment grade.

Aquila stated the risk to customer deposits in the event of bankruptcy is minimal. In any case, all priority claims must be paid in full before a Chapter 11 bankruptcy reorganization plan can be confirmed.

**B. Consumer Advocate's argument**

Consumer Advocate witness Vitale testified that Aquila's proposal to pledge its Iowa utility operations as collateral would harm utility customers because it unnecessarily encumbers those Iowa utility operations for a loan that is not needed for Iowa operations and ties Aquila's Iowa utility customers indefinitely to a financially weakened firm. Furthermore, Mr. Vitale testified that in the event of a bankruptcy, Aquila has made its utility customers worse off by agreeing to this term loan. Under this new loan, the secured creditors' claims come before those of utility customers.

Mr. Vitale recognized that cash was not pledged as security for the loan, but he testified the fact that cash is not pledged does not fully insulate customers, because if bankruptcy occurs, there may be little cash on hand. If there is not sufficient cash on hand, customers will come behind secured lenders for claims on any proceeds of the secured assets.

Mr. Vitale testified that Aquila's commitments to maintain its capital allocation process and to allocate investment grade rates for new or replacement debt do not adequately protect utility ratepayers. This internal allocation of the loan proceeds is a methodology that has been rejected by the Board in the past and the requirement that Aquila make advance payment for the purchase of gas supplies are a direct result of Aquila's poor financial condition caused by the nonregulated activities.

**C. Board analysis**

The Board finds that while Aquila is not able to quantify the potential financial impact on ratepayers of this reorganization, it has committed to maintain its capital allocation process that utilizes hypothetical capital structures and long-term debt assignments and to ensure that customers pay rates based on new or replacement debt as if such debt were investment grade. However, as noted by Consumer Advocate, the internal allocation of the loan proceeds is a methodology that has been rejected by the Board in the past and the assignment of capital costs given Aquila's commingled structure has been, and will likely continue to be, a controversial topic. The Board retains the authority to determine which capital costs are reasonable and

may be allowed in determining the revenue requirement and rates in a general rate proceeding.

Consumer Advocate argued that pledging utility assets would place utility customer deposits at greater risk of loss in a bankruptcy proceeding because the lender has a right to have its debt paid out of the secured assets before any proceeds of such assets are available to pay unsecured creditors. However, according to Aquila all priority claims (including claims for customer deposits) must be paid in full before the bankruptcy court would confirm a Chapter 11 reorganization, so the customer risk in this respect is not substantially increased.

The detrimental impact of Aquila's nonregulated businesses upon the ability of the utility operations to secure loans and maintain financial viability has violated the commitments made by Aquila when seeking Board review of previous reorganizations. Aquila is again providing the Board with assurances that it will protect ratepayers from any adverse consequences from the pledge of assets. Based on Aquila's history, the Board is understandably reluctant to accept these commitments at face value. However, the evidence appears to indicate that the proposed pledge will have little or no effect on ratepayers and may have a positive effect on Aquila's ability to complete its restructuring Plan, which should ultimately benefit ratepayers.

Aquila's Plan to become a 100 percent domestic utility is, in effect, a concession that its past business plans and corporate structure were flawed or inappropriate. The Board expects that Aquila management is sincere in its

commitments to return to its basic business and to recognize that operation of a public utility is a public trust and should not be used in a manner that violates that trust.

The Board finds that the potential that ratepayers will be detrimentally affected is greater if Aquila is not successful in weathering its financial difficulties and goes into bankruptcy. The evidence indicates the pledge of assets will have little or no effect on ratepayers in the near future but may provide some aid to Aquila in weathering this crisis. The Board finds that the proposal for reorganization should not be disapproved on the basis of a detriment to ratepayers.

## **5. Whether The Public Interest Is Detrimentally Affected**

### **A. Aquila's argument**

Aquila contended that the public interest would not be detrimentally affected by the proposed pledge of Iowa utility assets. The interests of secured creditors, unsecured creditors, employees, and shareholders are all at greater risk in a bankruptcy than in the proposed financial restructuring. While denial of Aquila's proposal for reorganization by itself would not cause Aquila to file for bankruptcy, denial would cause Aquila's restructuring to be more expensive and, therefore, would reduce the chance for a successful restructuring outside of bankruptcy. Consumer Advocate's claim that the proposed pledge is detrimental to the public interest because it secures debt unrelated to those assets and continues commingling unrelated business interests with regulated utility operations does not take into

account the affect of the proposed pledge of assets on any stakeholder group other than the ratepayers.

**B. Consumer Advocate's argument**

Consumer Advocate agreed that restoring Aquila's financial strength and regaining an investment grade credit rating for its utility interests is in the public interest, but contended that this proposal for reorganization is not. Pledging Iowa utility assets would be detrimental to the public interest because Aquila proposes to pledge assets for the purpose of securing debt that is unrelated to those assets. This would allow Aquila to continue its policy of commingling regulated and unregulated finances, the same policy that led to the deterioration and impairment of Aquila's regulated utility credit rating.

Using utility assets to secure unrelated debt would be detrimental to the public interest because it would unnecessarily increase the risk to the utility operations. Furthermore, Aquila is asking the Board to approve the use of regulated utility assets to secure debt for nonregulated business operations that the Federal Energy Regulatory Commission (FERC) has just prohibited based on the perceived threat to the public interest. Westar Energy, Inc., Docket No. ES02-51-000, "Order Conditionally Granting Authorization to Issue Long-Term Unsecured Debt and Announcing New Policy on Conditioning Securities Authorizations," 102 FERC ¶ 61,186 (Feb. 21, 2003).

Consumer Advocate witness Vitale testified that it is not in the public interest to have Iowa utility operations and vital services dependent on a financially

distressed firm that continues to fail to correct the structural flaws that created this credit crisis. Mr. Vitale also testified that pledging Iowa utility assets as collateral for this loan, which is not needed for its Iowa utility operations and that may be used to support Aquila's other operations, including its unregulated operations, is not in the public interest. Mr. Vitale concluded that Aquila's ability to secure the most favorable financing terms for this purpose is not in the public interest, but is in the interest of the lenders.

**C. Board analysis**

The Board finds that the interests of the public, which includes the various stakeholders and members of the public in general, are better served under a financial restructuring Plan than in bankruptcy, and the pledging of Iowa utility assets improves Aquila's chances of avoiding bankruptcy. To the extent that pledging reduces the chances of a bankruptcy, the adverse effects of Aquila's past decisions upon stockholders, secured creditors, unsecured creditors, employees, and customers will be reduced.

The Board understands the concerns expressed by Consumer Advocate that the public interest is detrimentally affected by the continued commingling of regulated and nonregulated operations. Aquila's plan to exit all non-utility businesses should address some of these concerns. In addition, Aquila has committed not to start any new unregulated business ventures through 2005, which is also a requirement of the loan agreement. On that basis, the Board finds that the overall public interest is not



detrimentally affected to a sufficient extent to require or support disapproval of the proposed reorganization.

## **OTHER FACTORS**

In addition to the five statutory factors, the Board examined other issues in this reorganization.

### **1. Aquila's Working Capital Requirements**

#### **A. Aquila**

Aquila calculated it would need \$250 million to support the ongoing working capital requirements of its domestic utility business. This determination is the result of an internal study of Aquila's domestic utility working cash needs using detailed budget information supporting the Plan. Aquila witness Dobson described the methodology, assumptions, and results of the study in his testimony and Exhibit 116. Aquila witness Armstrong testified that Aquila would use a standard lead-lag study if this were a rate case, but the calculation of working capital for financing purposes is different. Working capital for financing purposes requires a calculation of the amount of cash the company may need to meet peak day purchases during the year. An analysis of working capital in a rate case provides an average annual need and does not address peak day requirements.

Ms. Armstrong then testified that the working capital study is designed to calculate the net cash outstanding daily balance. In order to arrive at this figure, both cash disbursements and cash receipts were considered. Based on this study,

Aquila determined that the peak cash requirement occurs in the first few days of January. This peak is driven by gas supply purchases lagging the collection of cash during this high demand period. Gas supply payments outstanding during the first few days of January include: 1) payment for gas used in December (the study assumes the December gas is predominantly collected in January based on the billing cycles); 2) the prepayment of January gas; 3) payments for gas injected into storage minus an amount for gas removed from storage through early January; and 4) prepaid pipeline capacity charges. The total cash outstanding was then netted with the estimated cash receipts for the month of January. The January 2004 estimated cash receipts have been increased over 2003 actual receipts to include the effect of increased gas costs.

**B. Consumer Advocate**

Consumer Advocate argued Aquila has not demonstrated that any working capital is actually needed for its Iowa utility operations and assets located in one state and used to serve that state's customers should not be pledged to secure debts beyond the amount needed to finance the operations in that state. Consumer Advocate asserted that Aquila's study of Iowa's working capital needs is flawed and, even if accepted at face value, the Iowa specific study shows the primary reason Iowa utility operations would need working capital is because of special credit restrictions imposed by gas sellers and transporters due to Aquila's weakened financial situation. Those restrictions do not apply to a prudently managed,

investment grade utility. Therefore, Iowa utility assets should not be put at risk to secure the financing.

**C. Board analysis**

The Board finds the evidence shows that the calculation of working capital for financial purposes can be based upon factors other than the calculation of a cash working capital requirement for ratemaking purposes. Further, the Board finds that in the particular circumstances of this proceeding, Aquila's peak working capital calculation methodology provides a more appropriate estimation of working capital needs for credit securitization and financing than does the traditional cash working capital calculation used in ratemaking proceedings.

Exhibit 112 shows that the cost of natural gas is the primary driver of working capital needs for the utility business and this cost is driven by the peak day demands of the company. The Board recognizes that Aquila's suppliers of natural gas are requiring prepayment from Aquila and this is the result of the financial problems caused by Aquila's nonregulated debt. This fact, however, does not render the calculations made by Aquila unreasonable.

Rate case methodology involves calculating an annual average, while in this proceeding Aquila is calculating a peak requirement for financing purposes. The standard lead-lag methodology used in rate cases may not adequately cover peak working capital needs for financing purposes. Moreover, the Board considers it prudent for Aquila to allow for colder than normal weather conditions and higher natural gas prices in its calculations. Based on all of these factors, the Board

concludes that the three-year term loan is reasonably necessary to ensure Aquila has adequate capital to support its working capital needs, especially under current market conditions of high gas costs and the potential for severe winter weather.

## **2. Insulation (Ring-Fencing) Requirements**

### **A. Aquila**

Aquila argues that its capital allocation process is an internal “ring-fencing” mechanism designed to insulate Aquila’s utility business on a credit, financial, and operational perspective from its nonregulated businesses. Aquila asserts that regulators in Minnesota, Kansas, Missouri, and Colorado have acknowledged this. Although internal corporate policies may be a weaker ring-fencing method than legal, regulatory, or contractual mechanisms, nevertheless, corporate policies are helpful indicators of management intent. Aquila relies upon its internal mechanisms to isolate risk and insulate Aquila’s customers.

Aquila argued that the Board should reject Consumer Advocate’s suggestion that Aquila should be required to establish a holding-company structure as a condition of the Board’s approval of Aquila’s proposal. Aquila claimed that the loan agreement prohibits Aquila from establishing a holding company structure and transferring assets to a subsidiary. Any attempt at this time would likely cause existing creditors to force Aquila into bankruptcy immediately. Furthermore, restrictions imposed by the Public Utility Holding Company Act (PUHCA), such as the requirement that utility operations be contiguous, makes the holding company structure incompatible with Aquila’s operations. In addition, Aquila contended that

structural separation is neither necessary nor useful because Aquila is exiting all non-utility business.

**B. Consumer Advocate**

Consumer Advocate argued that Aquila's proposal to pledge its Iowa utility assets as collateral continues to leave these operations at risk and does not address the underlying cause of this financial crisis, the commingling of regulated and nonregulated finances. Aquila should either divest itself of all non-utility assets or, in the alternative, create separate legal entities for regulated utility operations, on the one hand, and any other business interests on the other, with fully separate accounting sufficient to establish separate credit ratings.

Consumer Advocate pointed out that the essential purpose of ring fencing is not merely to provide an accurate description of assets that are within the fence but to protect those assets from credit risk. Consumer Advocate suggested that Aquila is wrong when it asserts that its internal capital allocation process insulates its utility divisions from its other activities. This is demonstrated by the fact that Aquila's current credit crisis adversely affects all of its operations, including the regulated ones. Aquila will not be able to successfully interpose its paper ring fencing as a defense if the lenders take legal action to enforce their liens.

Finally, Consumer Advocate stated that, while the holding company structure may be imperfect, it provides more protection than Aquila's current corporate structure, which commingles regulated and unregulated operations. For example, while Enron Corporation's utility subsidiary, Portland General Electric Company

(Portland General), was exposed to asset impairment and liabilities because of its association with Enron Corporation, nevertheless, the holding company structure has been instrumental in helping Portland General avoid being part of Enron Corporation's bankruptcy. (Exhibit 103.)

Consumer Advocate argued that the restrictions placed on Aquila by the loan are not an impediment to the eventual adoption of a prudent corporate structure. A holding company corporate structure could be implemented when the restrictions in the loan agreement expire or with the consent of the lenders.

**C. Board analysis**

The Board finds that recent trends of rating agencies have caused concern over the risks involved in commingling regulated and nonregulated business operations. Exhibit 109 contains a recent report from the National Association of Regulatory Utility Commissioner's Staff Subcommittee on Accounting and Finance that discusses recent trends of rating agencies. The report states that the rating agencies' tendency to consolidate utilities and nonregulated affiliated companies when evaluating risks has caused an increasing concern over the impact of nonregulated ventures upon the utility's access to debt and equity capital and the corresponding cost of such capital as well as the prospect of the utility being pulled into bankruptcy by its parent's insolvency. Rating agencies have also indicated that the less common structure where the regulated utility operates as a division of the parent company, as in the case of Aquila, results in a higher risk profile for the utility. (Exhibit 203.)

The Board understands that to the extent Aquila realizes its plan of exiting all non-utility business, structural separation is neither necessary nor useful. If no nonregulated business exists, then there is no need to insulate the utility from the potential adverse effects of it and the concerns of the rating agencies are avoided. Furthermore, both PUHCA and the loan agreement constraints appear to make restructuring very difficult at this time.

Nevertheless, the Board finds that separation may be needed if the restructuring Plan is not fully implemented. Aquila's credit crisis has adversely affected the utility operations because of Aquila's commingled structure. Continued commingling of regulated and nonregulated operations may, in the future, require a holding company structure and other ring-fencing mechanisms to insulate the utility from the risks of the nonregulated operations.

### **3. The Effect Of Bankruptcy On Aquila Operations**

The Board finds that on balance the evidence indicates that the pledging of the Iowa utility assets will help Aquila through its current financial crisis and help Aquila avoid bankruptcy. Pledging Iowa assets may not be enough to ensure that Aquila avoids bankruptcy in the future, but under current conditions, pledging the assets should have a positive effect on Aquila's access to capital markets. This may be crucial for Aquila to implement the restructuring Plan and thereby avert bankruptcy. In addition, the pledging of Iowa assets should enable Aquila to meet the requirement to reduce the interest rate on the loan and thus realize a savings of

\$3.225 million of annual interest expense, which will further aid the bankruptcy avoidance process.

Consumer Advocate argued that because the financial crisis was a result of management decisions, only the stockholders and management should feel the adverse consequences of the failed nonregulated ventures. Unfortunately, given the commingled organizational structure of Aquila, it is difficult, if not impossible, to let the market punish the nonregulated part for its mistakes without also adversely affecting the regulated part. Furthermore, it is also unrealistic to expect the regulated part to regain its credit rating unless problems of the nonregulated parts of the company are somehow addressed. Overall, the Board is not persuaded that ratepayers or the public interest would be better served by Aquila filing for bankruptcy. This is true even though there is some risk to ratepayers from Aquila's continuing weakened financial condition. The Board finds there is a greater risk to ratepayers if Aquila is forced to file for bankruptcy and, as a result, the Board's regulatory oversight of Aquila's operations is adversely affected.

Aquila appears to be making an effort to avoid bankruptcy and it should be allowed to pledge the Iowa utility assets in this effort to acquire better access to the capital markets. Bankruptcy is the most drastic option for Aquila's financial problems. Disapproving the proposal for reorganization could reduce Aquila's ability to stay out of bankruptcy and thus reduce the Board's ability to oversee Aquila operations and ensure that Aquila customers receive safe, reasonable, and adequate service.



#### **4. Conditional Approval**

Consumer Advocate suggested several conditions to be placed on any decision by the Board to not disapprove the proposal for reorganization. These conditions are:

1. Board action to not disapprove should apply only to the current loan agreement but not to any extensions, amendments, or renewals of it.
2. Value of Iowa-based collateral to be pledged should be limited to working capital for the Iowa operations.
3. Commitment from Aquila to divest itself of all non-electric or gas utility assets within three years or, in the alternative, to create separate legal entities for regulated electric and gas utility operations on the one hand, and any other business interests on the other, with fully separate accounting sufficient to establish separate credit ratings.
4. Commitment to structure future financings for non-electric and gas utility operations separately and in a manner that prevents lenders from executing on utility assets to satisfy the obligations.
5. In the event Aquila creates separate legal entities for the operation of the utility business, to comply with all rules of the FERC in regard to accounting for, allocating, and discharging debt pertaining to that entity.

Aquila argued that the Board does not have authority under the statute to place conditions on a decision not to disapprove. Aquila opposed the imposition of

any conditions as a prerequisite to the Board acting favorably on the proposal for reorganization.

Iowa Code § 476.77 provides that “[a] reorganization shall not take place if the board disapproves.” This statutory language could be read to limit the Board's authority to either disapproving the proposal or not disapproving the proposal. However, the Board has determined in previous cases under this statute that it can disapprove a proposal for reorganization and indicate to the utility what corrections or conditions need to be made or added to make the proposal acceptable.

The Board agrees with Consumer's Advocate suggestion that Aquila should not be granted the authority to extend, amend, or renew the three-year loan agreement without additional review in a future reorganization proceeding. Even though this may insert some regulatory uncertainty into Aquila's ability to obtain adequate credit in the future, the Board must retain its regulatory oversight of Aquila's future activities and its ability to consider the circumstances prevailing at that time.

Requiring Aquila to file a proposal for reorganization for any additional pledge of Iowa utility assets will allow the Board to monitor the commitments made in this docket. The Board will be able to monitor Aquila's movement toward its goal of a regulated domestic utility company.

Since Aquila seeks to become a regulated domestic utility company, its announced goal is aligned with Consumer Advocate's position and suggested condition that Aquila divest itself of all non-electric or gas utility assets. Though the Board understands Consumer Advocate's motivation, it will not order such a

condition, but will monitor Aquila's progress in reaching its goal. As discussed in the Insulation Requirements section of this order, Aquila's realization of its goal will make it unnecessary for the Board to consider ring-fencing and whether Aquila should change its corporate structure.

The Board has already discussed the unfortunate impact of commingling of assets and obligations between regulated and non-regulated operations. So, though it understands Consumer Advocate's point in suggesting a condition that the "value of Iowa-based collateral to be pledged should be limited to working capital for the Iowa operations," the Board will not require such a condition.

## **5. Aquila Commitments**

Aquila has made several commitments to the Board if the Board acts favorably on the proposal for reorganization. These commitments are as follows:

1. Senior Vice-President Empson testified that he would recommend to senior management that Aquila commit to obtaining approval from the Iowa Utilities Board before its starts any new unregulated business ventures after the year 2005.
2. In the event there is a bankruptcy, foreclosure, or liquidation involving Aquila's assets located in Iowa, or other need to transfer Aquila's assets located in Iowa, Aquila will advise other parties to any such actions that the Iowa Utilities Board would require the filing and approval of an application to transfer Aquila's assets located in Iowa, pursuant to 199 IAC 32 and Iowa Code § 476.76 and 77.

3. Aquila will come before this Board with a subsequent application for reorganization if utility assets in excess of \$718.1 million are needed and opportunities arise to issue more debt or to retire higher cost debt.

The Board will require that Aquila inform the Board in writing of its intent to follow Mr. Empson 's first two recommendations. Additionally, the Board has explicitly based its decision in this case on the third commitment, as well as the material representations made by Aquila in the record. Even though the commitments appear to be only assurances that Aquila will comply with the relevant statutes and Board rules, the Board finds that they support the decision.

### **CONCLUSION**

The Board determines, based on an analysis of the five statutory factors and the other relevant factors discussed in this order, that it is not against the interest of ratepayers and the public to allow Aquila to pledge Iowa utility assets to secure the three-year term loan as proposed, provided that Aquila accepts the Board's conditions. This is a difficult decision for the Board. The Board watched with concern while Aquila used the stability and cash flow from its regulated companies to expand into nonregulated and international businesses. Aquila was aggressive in seeking Board approval for these ventures on the premise that the unregulated activities would not impact the utility operation.

As a result of its expansion activities, Aquila is now back before the Board seeking its help in remaining a viable corporate entity through the pledge of regulated assets.

The Board finds, based upon the evidence in this docket, that Aquila needs help now and the pledging of the assets will provide some help. Further, the goal of Aquila's restructuring plan (to become a utility-only company) appears to be in the public interest. For these reasons, the Board will not disapprove the proposal for reorganization, provided that Aquila accepts the Board's conditions.

However, the Board will not grant Aquila the authority to extend or rollover the pledge of assets beyond the three-year term of the loan without filing another proposal for reorganization. Aquila management has not performed in a manner to warrant the granting of open-ended authority.

The Board, in this decision, is deferring Consumer Advocate's recommendation concerning a holding company structure to a later docket. If Aquila is successful in becoming a utility-only corporation, then there may be no need for a change in the corporate structure. Since Aquila has committed to obtain approval from the Board before it starts any new nonregulated businesses in the future, the Board will be able to reconsider Consumer Advocate's recommendation should Aquila solicit such an approval.

In addition to the decision to allow the pledging of Iowa utility assets, the Board will require Aquila to file reports concerning its progress in implementing the debt and restructuring plan, including the capital investments made by Aquila in Iowa

and reporting of leak call response times of more than 60 minutes. The Board will also require Aquila to continue to use Gallup (or similar) surveys regarding service quality and customer satisfaction and file the results. Aquila must also file any decisions concerning the pledging of utility assets in other states.

### **ORDERING CLAUSES**

#### **IT IS THEREFORE ORDERED:**

1. The Utilities Board will exercise the statutory authority provided in Iowa Code § 476.77 to disapprove the proposal for reorganization filed by Aquila, Inc., d/b/a Aquila Networks, on April 30, 2003, to pledge its Iowa utility assets to support a \$430 million three-year term loan, unless Aquila agrees in writing within ten business days to the conditions cited in ordering clauses 3 and 4 below.

2. The request to extend or rollover the pledging of Iowa utility assets beyond the three-year term of the loan agreement filed by Aquila, Inc., d/b/a Aquila Networks, on April 30, 2003, is disapproved.

3. Aquila, Inc., d/b/a Aquila Networks, shall file the following with the Board:

a. A report every six months after the date of this order for the next three years detailing the actions taken to implement the debt and restructuring plan. Each report will include a detailed list of capital investments made in Iowa over the three calendar years following the pledging of Iowa-jurisdictional

assets and those made in 2001, 2002, and 2003 to be used as a benchmark against those future investments.

b. A report every month listing the leak call response times over 60 minutes and an explanation of any delays in responding within 60 minutes for each call.

c. Gallup (or equivalent) surveys that Aquila will continue to have conducted by or for Aquila concerning service quality and customer satisfaction.

d. A copy of all decisions concerning the pledging of utility assets made by other states, regulatory commissions, or similar authorities.

4. Aquila shall fulfill the commitments it has made in this docket, including but not limited to the following:

a. Recommend to senior management that Aquila commit to obtain approval from the Iowa Utilities Board before its starts any new unregulated business ventures after the year 2005.

b. In the event there is a bankruptcy, foreclosure, or liquidation involving Aquila's assets located in Iowa, or other need to transfer Aquila's assets located in Iowa, advise other parties to any such actions that the Iowa Utilities Board would require the filing and approval of an application to transfer Aquila's assets located in Iowa, pursuant to 199 IAC 32 and Iowa Code § 476.76 and .77.

5. The Board's action in this docket is explicitly based upon the evidence presented. If there are any material changes in any of the information considered by the Board in making its decisions, up to the time the transaction is closed, Aquila shall promptly inform the Board of the changes. The filing shall include an analysis of the impact of the changes. Any closing shall be delayed by a minimum of five business days to permit the Board and the parties to this proceeding an opportunity to evaluate the potential impact of the change.

**UTILITIES BOARD**

/s/ Diane Munns

/s/ Mark O. Lambert

ATTEST:

/s/ Judi K. Cooper  
Executive Secretary

/s/ Elliott Smith

Dated at Des Moines, Iowa, this 27<sup>th</sup> day of October, 2003.